

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

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|--|---|----------------|
| THE CONSIDERATION AND DETERMINATION |) | |
| OF THE APPROPRIATENESS OF IMPLEMENTING |) | |
| A RATEMAKING STANDARD PERTAINING TO |) | ADMINISTRATIVE |
| THE PURCHASE OF LONG-TERM WHOLESALE |) | CASE NO. 350 |
| POWER BY ELECTRIC UTILITIES AS |) | |
| REQUIRED IN SECTION 712 OF THE ENERGY |) | |
| POLICY ACT OF 1992 |) | |

O R D E R

On May 21, 1993, the Commission issued an Order initiating this case to perform a general evaluation of four considerations cited in Section 712 of the 1992 Energy Policy Act ("EPACT"), 16 U.S.C. §2601, concerning utilities' purchases of long-term wholesale power. As the Commission does permit jurisdictional utilities to purchase wholesale power supplies, Section 712 requires evaluation of the following:

1. The potential for changes in a utility's cost of capital, and any resulting changes in retail rates that may result from purchases of long-term wholesale power in lieu of constructing generation facilities.

2. Whether the use by exempt wholesale generators of capital structures which employ proportionally greater amounts of debt than the capital structures of such utilities threatens reliability or provides an unfair advantage for exempt wholesale generators over such utilities.

3. Whether to implement procedures for the advance approval or disapproval of the purchase of a particular long-term wholesale power supply.

4. Whether to require as a condition for the approval of the purchase of power that there be reasonable assurances of fuel supply adequacy.

The Order of May 21, 1993 made Big Rivers Electric Corporation ("Big Rivers"), East Kentucky Power Cooperative ("East Kentucky"), Louisville Gas & Electric Company ("LG&E"), Kentucky Power Company ("Kentucky Power"), Kentucky Utilities Company ("KU"), and The Union Light, Heat & Power Company ("ULH&P") parties to this proceeding. The Attorney General of the Commonwealth, by and through his Utility Rate Intervention Division ("AG"), Salt River Electric Cooperative Corporation, Kentucky Industrial Utility Customers, and the Electric Generation Association ("EGA") requested and were granted intervention. Comments were received by July 9, 1993 and the case stands submitted.

COST OF CAPITAL

The Commission must evaluate the potential for changes in the cost of capital and resulting changes in retail rates for utilities that purchase power rather than build generation facilities.

KU addressed this issue extensively asserting that the Commission needs to assess contracts for wholesale power qualitatively rather than quantitatively to determine who bears the

risk. KU believes that, depending on the terms of the contract, business and financial risk can either be shifted to the utility or remain with the exempt wholesale generator ("EWG"). It urges the Commission to adopt a policy which:

- (1) strongly encourages all utilities to negotiate purchased power agreements that effectively shift the financial, business, and other risks to the non-utility generator,

- (2) maintains Public Utility Regulatory Policy Act of 1978 ("PURPA") standards that accurately reflect avoided cost and do not promote PURPA projects at ratepayer or stockholder expense, and

- (3) provides electric utilities the genuine option of pursuing economic purchased power as a planning tool to avoid or forestall the need to build new generating facilities.

LG&E's comments focused on the risk of being "second guessed" by the Commission on the prudence of the purchase if demand fails to materialize as anticipated. It is also concerned that utilities will forego opportunities to purchase power in order to build capacity to further their financial growth. To encourage utilities to select the purchase option, LG&E urges the Commission to adopt incentive regulation to make the utilities financially indifferent to either decision.

The joint comments of Kentucky Power, East Kentucky, and Big Rivers ("Joint Respondents") warn of an increase in both investment and business risk if a utility relies too heavily on purchased power. They conclude that:

The question of how retail rates paid by customers are ultimately affected is actually a question of how the incremental increase in the cost of equity capital interacts with all other factors in a utility's cost-of-service. [Emphasis supplied.]¹

EGA contends that credit rating agencies do not view capacity payments to EWGs as debt. It, therefore, opines that a rating agency's assessment of risk is affected only by the terms of a purchase contract and by the potential for Commission disallowance of purchase costs in rates.

The AG commented that avoiding the risks of building capacity could outweigh any risks associated with the decision to purchase power. He stated that no action is needed from the Commission because the cost of capital is examined in rate cases where appropriate adjustments for changes in risk should be made.

The Commission believes that purchases of wholesale power in lieu of constructing generating facilities can have either a positive or negative effect on a utility's cost of capital. Although EPACT apparently focused on the scenario of purchases causing a higher cost of capital, the Commission agrees with the AG that the risk affecting the cost of capital is properly assessed in a rate case and that no further consideration is necessary at this time.

As to LG&E's recommendation that an incentive mechanism be adopted to offset what may be an inherent financial bias in favor of constructing generating facilities, the Commission declines.

¹ Joint comments of Kentucky Power Company, East Kentucky Power Cooperative, Inc., Big Rivers Electric Corporation, filed July 9, 1993, page 6.

While electric utilities have long enjoyed the benefits of a regulated monopoly, competition is becoming more prevalent within the industry. All jurisdictional electric utilities should be intent on delivering electricity at the lowest possible cost. Furthermore, in any case involving the certification of generating facilities, the utility will have to demonstrate that it explored all available options including purchasing power. The Commission agrees with the intent of KU's suggested policies and encourages all electric utilities to consider these principles fully when deciding to purchase or build.

EWG CAPITAL STRUCTURES

Next, the Commission must evaluate whether heavily leveraged capital structures of EWGs threaten their reliability or provide unfair advantages over utilities. According to KU, an EWG has an unfair advantage over electric utilities as it can employ a greater amount of debt than a utility. KU also believes that a highly leveraged EWG can become unreliable if it experiences operating problems and lacks the financial ability to correct them. In such a situation, a utility would be forced to either pay additional monies to avoid losing the power supply or face an impaired ability to provide service. KU further contends that the low price which can be offered by a highly leveraged EWG may allow it an unfair advantage when selling power if the potential buyer ignores reliability when deciding to purchase. KU therefore urges the Commission to require EWGs to maintain capital structure ratios comparable to electric utilities.

Similarly, the Joint Respondents noted the problems of reliability for a highly leveraged EWG and urged the Commission to consider regulating EWGs' financial arrangements and requiring them to maintain the same relative capital structure as investor-owned electric utilities. These steps should be taken to protect the public interest and create a level playing field.

LG&E stated that the financing decisions made by EWGs are much more profit driven than those of the utilities because the EWGs are not obligated to serve or maintain the reliability necessary to meet human needs. Stated conversely, utilities which cannot simply cease to operate may be unable to carry as much debt as an EWG. However, LG&E states that issues concerning capital structure are less important in a highly competitive market where the marketplace determines the price, not the capital structure of the suppliers. As a practical matter, suppliers with large equity ratios will no doubt be able to compete successfully with highly leveraged firms and vice versa.

According to the EGA, an EWG's ability to employ a highly leveraged capital structure does not necessarily convert to a lower cost of capital, thereby creating an unfair advantage. Higher leverage forces equity returns upward, resulting in overall capital costs similar to those with less leverage. The EGA does not consider reliability to be a problem.

The AG contends that a highly leveraged EWG may have a higher cost of capital than a utility, all other factors being equal. He recommends that reliability factors should be handled through power

purchase contracts which can protect the utility and its ratepayers if they contain penalties for nonperformance resulting from improper capitalization or any other reason.

The Commission finds that the market will operate to assign prices based on overall risk, not simply the risk associated with a highly leveraged capital structure. A utility can purchase power if that is the least cost option. On the other hand, a utility can build for its own use if that is the least cost option. Moreover, a utility holding company is not restricted from building an EWG for nonaffiliated sales incorporating the maximum degree of leverage the market will bear.

Assuming the Commission has jurisdiction to do so, no benefit to regulating an EWG's capital structure is apparent. The market for purchased power will assign appropriate risks via prices more efficiently than the Commission can. However, the Commission notes that a utility has a statutory obligation to serve the public. Any contract to purchase power should contain terms sufficient to ensure that the security of supply is maximized. It is the responsibility of the utility to negotiate contract terms which, to the maximum extent possible, assure reliable power at the lowest cost consistent with that degree of reliability.

PRE-APPROVAL OF LONG-TERM PURCHASES

The third issue requires the Commission to consider whether it should formulate a pre-approval process for long-term purchases of electricity.

LG&E, the AG, and the EGA all favor pre-approval of long-term purchase contracts. LG&E and EGA are concerned with eliminating the risk of future disallowance, whereas the AG suggests that prudence reviews should not await rate cases.

KU and the Joint Respondents favor pre-approval only if a utility requests it to eliminate the risk of future disallowance. Otherwise, they urge adoption of guidelines which consider price and nonprice factors which utilities may use when deciding on wholesale power purchases. KU suggested the following criteria for such guidelines: capital structure of the developer or project; apportionment of financial, business, and other risks between the utility and the EWG; minimum performance standards; technology used to generate power; level and schedule of required capacity and energy payments; status of project development; demonstrated financial viability of the project and the developer; a developer's prior experience in the field; system fuel diversity and assurance of supply; dispatchability, project location and effect on the transmission grid; and environmental impact. Several comments implied that the Commission should also develop an automatic adjustment clause for purchased power.

The Commission finds that in this era of increasing competition, utilities should be able to purchase power without prior Commission approval. However, recognizing the significant risk created by a subsequent rate disallowance, utilities are encouraged to file such contracts for prior approval. In addition, these contracts may well require prior approval under KRS 278.300

if they constitute evidences of indebtedness. In particular, the inclusion in such contracts of minimum payment obligations or take/pay provisions may necessitate prior approval. The guidelines proposed by KU appear reasonable and should be seriously considered by all electric utilities in their decision-making processes.

The Commission is not persuaded that an automatic purchased power clause needs to be adopted at this time. A general rate case is the most appropriate forum to review a utility's revenue needs. If a utility's annual payments for purchased power fluctuate significantly, the Commission will consider, on a case specific basis, the need for a purchased power clause.

FUEL SUPPLY ASSURANCE

The final issue to be considered is whether to require, as a condition for approval of power purchases, reasonable assurances of fuel supply adequacy. All respondents agree that an adequate fuel supply is an important factor in a utility's decision to sign a long-term purchase power contract. However, not all respondents agree that the Commission should evaluate this factor in the same manner. The AG advises the Commission to consider fuel supply assurance to protect ratepayers but cautions against being so strict as to discourage EWG development. He also noted that an untoward emphasis on fuel supply assurance would discourage EWGs that rely on clean renewable fuel sources which by their nature cannot be stored.

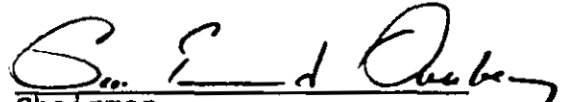
The Commission agrees that an adequate fuel supply is an important issue to be considered when reviewing purchased power


contracts. This factor will be closely scrutinized in any formal review of such contracts.

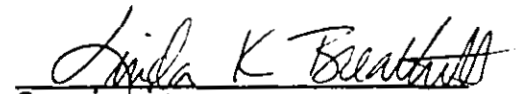
IT IS THEREFORE ORDERED that this docket be and it hereby is closed.

Done at Frankfort, Kentucky, this 25th day of October, 1993.

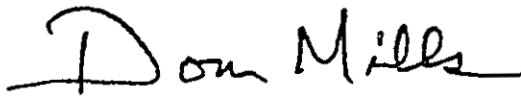
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